Internal Revenue Service

memorandum

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TS/WHEARD

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to: District Counsel, Philadelphia MA:PHI
Attn: Steve Doraghazi

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subjec [redacted]

TL-N-8282-90
CC:TL:TS Heard Wilson
I.R.C. §§ 6501, 6229(a), 6231(a)(4) & (5)
Basis as affected item subject to nonpartnership period for assessment

This memorandum is in response to your request for tax litigation advice received by this office on July 5, 1990.

ISSUES

1. What number of shareholders must a subchapter S corporation have to fall under the small subchapter S corporation exception to TEFRA for years prior to the effective date of the regulations?

2. Is a shareholder's basis in his subchapter S corporation interest an affected item subject to notice of deficiency procedures?

3. If so, may a notice of deficiency be issued for such items although an entity level proceeding has not taken place?

4. Assuming a notice of deficiency proceeding is appropriate, what is the relevant period for issuing a timely notice?

CONCLUSIONS

1. The small S corporation exception to the unified audit and litigation procedures is limited to one shareholder S corporations for tax years the return for which is due on or before January 29, 1987.

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2. Under the recent opinion in Dial U.S.A., Inc. v. Commissioner, 95 T.C. No. 1 (July 2, 1990), basis of a shareholder in his subchapter S corporate interest is not a partnership item and is thus subject to notice of deficiency procedures.

3. The Tax Court also recently held in Roberts v. Commissioner, 94 T.C. No. 53 (June 11, 1990), that an affected item notice of deficiency may be issued notwithstanding that no entity level proceeding has preceded the issuance of the notice, as long as nonpartnership item determinations do not need to await entity level determinations.

4. It is the position of this office that section 6229(a) provides a separate period of limitations on assessment for partnership and affected items. Since neither a notice of final partnership administrative adjustment (FPAA) nor a notice of deficiency was issued in this case prior to the expiration of this period, the applicable period of limitations on assessment has expired. I.R.C. §§ 6229(d) and 6503(a); Litigation Guideline Memorandum TL-81. Petitioners are thus entitled to summary judgement for the [redacted] and [redacted] taxable years.

For the [redacted] (non-TEFRA) taxable year, the only relevant period of limitations is the period of limitations for the shareholders under section 6501. Since this period was open when the notice of deficiency was issued, petitioners are not entitled to summary judgement with respect to this year.

FACTS

Petitioners were one1/ of [redacted] investors in [redacted], an S corporation for the years [redacted] through [redacted], the years currently before the court. A notice of deficiency was issued on [redacted] for the taxable years [redacted], [redacted] and [redacted]. The period of limitations on assessment under section 6501 was open with respect to all years at the time the notice was issued pursuant to an extension under section 6501(c)(4) on a Form 872-A. The period of limitations for assessing partnership items under section 6229(a) had expired at the time the notice of deficiency was issued. Furthermore, the period of limitations on assessment relating to the S corporation itself under section 6501 had expired at the time the notice was issued.

1/ Section 6231(a)(1)(B)(II) provides that a husband and wife shall be treated as one partner. Temp. Treas. Reg. § 301.6241-1T(c)(2)(ii) extends this provision to a husband and wife who are shareholders.

The ground for the disallowance of subchapter S items is that the shareholder had insufficient basis in his S corporation interest to take all losses pursuant to section 1366(d)(1).

Petitioner filed a motion for summary judgement asserting that the items in questions were subchapter S items which could only be adjusted in a TEFRA proceeding, rather than the current deficiency proceeding. Petitioner argued in the alternative that even if deficiency procedures applied, they were time barred under Kelley v. Commissioner, 877 F.2d 756 (9th Cir. 1989) since the corporate section 6501 period for assessment had expired.

DISCUSSION

Section 6244 provides that

> The provisions of-
>
> (1) subchapter C which relate to-
>
> (A) assessing deficiencies . . . with respect to partnership items, and
>
> (B) judicial determination of partnership items . . . .
>
> are (except to the extent modified or made inapplicable in regulations) hereby extended to and made applicable to subchapter S items.

The Tax Court held in Blanco Investments & Land, Ltd. v. Commissioner, 89 T.C. 1169 (1987), that the small partnership exception contained in section 6231(a)(1)(B), which exempts partnerships with 10 or fewer partners from the TEFRA partnership procedures, also applies to S corporations. As a consequence, the Court held that a notice of final S corporation administrative adjustment (FSAA) issued under the unified audit and litigation provisions of sections 6241-6245 with respect to an S corporation having only one shareholder was invalid. The Court further held that due to the differences between S corporations and partnerships, the statute does not necessarily contemplate a small S corporation exception set at 10 or fewer shareholders in the absence of regulations providing for some lesser number. The Court expressly refrained from setting the size of the small S corporation exception, however, because to do so would usurp the role of the tax administrator. Hence, the Court merely ruled that the minimum and maximum limits of the exception are 1 and 10 shareholders, respectively, but otherwise left the actual size of the small S corporation exception as an open question.

The Court answered this question in 111 West 16 Street Owners, Inc. v. Commissioner, 90 T.C. 1243 (1988). The Court held that the Service properly exercised its discretion in that case applying the unified audit and litigation provisions of sections 6241-6245 with respect to an S corporation having 3 shareholders for a tax year (1983) for which regulations did not set an exception. The Court stated that in the absence of regulations the small S corporation exception to the unified audit and litigation procedures is limited to one shareholder S corporations for tax years the return for which is due on or before January 29, 1987.2/ For returns due after this date Temp. Treas. Reg. § 301.6241-1T(c)(2)(i) provides for a small S corporation exception set at 5 shareholders. 111 West 16 Street Owners, Inc. v. Commissioner, 90 T.C. at 1245; Blanco Investments and Land, Ltd. v. Commissioner, 89 T.C. at 1172-73.

This opinion leaves no room to argue that an S corporation with [redacted] shareholders falls under a small S corporation exception, regardless of whether the taxable year is subject to the exception set by regulations.3/ The "discretion" of the Service to set a number for a small subchapter S corporation exception referred to in the above cases is the discretion to apply or not apply the TEFRA procedure through regulations as provided in section 6244 quoted supra.

BASIS AS AN AFFECTED ITEM

Under Maxwell v. Commissioner, 87 T.C. 783 (1986), partnership (and subchapter S) items must be determined "solely in the partnership [subchapter S] proceeding." The Tax Court has recently held, however, that basis of a shareholder in a subchapter S corporation is not a subchapter S item which can be determined at the S corporation level. Dial U.S.A., Inc. v.

2/ More specifically the Court held that the statute only requires a single shareholder S corporation be excluded from the unified entity-level procedures and that setting the number of qualifying shareholders for the small S corporation exception at greater than one should be left to the Service's administrative discretion. The Court further held that, since petitioner did not show that applying the unified audit and litigation procedures would be futile or useless in the case at bar, there were no grounds for concluding that the Service abused its discretion in applying those procedures to the three shareholder case.

3/ Note that TEFRA was only made applicable to subchapter S corporations for taxable years beginning after December 31, 1982. For years beginning before this date, normal deficiency procedures apply.

Commissioner, 95 T.C. No. 1 (July 2, 1990). As a nonsubchapter S item or affected item, basis determinations can be made at the shareholder level following the TEFRA proceeding. Id. To the extent that basis will be comprised of partnership or subchapter S item elements, however, those elements which are determined in an entity level proceeding will be res judicata in subsequent affected item proceedings. Id.

Usually, a TEFRA entity proceeding must precede the issuance of an affected item notice of deficiency. N.C.F. Energy Partners, Ltd. v. Commissioner, 89 T.C. 741 (1987). In N.C.F. Energy Partners, the Court held that it had no jurisdiction over affected items until the partnership proceeding was completed. The rationale for this holding was that the affected items in question (additions to tax) could not be determined until the underlying partnership item adjustments were determined.

In Roberts v. Commissioner, 94 T.C. No. 53 (June 11, 1990), however, the Tax Court held that an affected item at risk determination could be made in a partner's personal tax case, notwithstanding that no partnership proceeding had taken place. The rationale for this holding was that the statute of limitations for issuing a notice of FPAA had expired shortly after the notice of deficiency was issued. Consequently, all partnership items reported on the partnership return were deemed to be correct. Since the at risk issue was not dependent on nor would be affected by a proceeding at the partnership level, a partnership proceeding was not a condition precedent for determining the affected or nonpartnership items. Id. distinguishing N.C.F. Energy Partners, Ltd. v. Commissioner, supra.

Where an affected item is dependent upon partnership or subchapter S items which need to first be determined, N.C.F. Energy Partners should be the applicable authority rather than Roberts, i.e., an entity proceeding must precede the issuance of affected items.

Application to instant facts

Normally, all the components of basis are comprised of partnership items. Sections 1011, 1012 and 722 provide that beginning basis is cost (i.e., a shareholder's initial contribution for stock or partner's contribution). Section 1367 and 705 set forth adjustments which will affect basis, i.e., a partner's/shareholder's allocable share of deductions, income, distributions, etc. Section 301.6245-1T and section 301.6231(a)(3)-1 provide that these same items are also partnership and subchapter S items.

The specific issue in the instant case is the amount of the shareholder contributions to the subchapter S corporation. Contributions by shareholders are specifically defined as subchapter S items. Temp. Treas. Reg. § 301.6245-1(T)(a)(5)(i). Subchapter S items are required to be determined at the corporate level. Maxwell v. Commissioner, supra. The amount of the shareholder's basis is dependent upon the determination of his contribution to the corporation.

Furthermore, since the amount of the contributions are not reported on the partnership return, there is no amount which can be "deemed correct" under Roberts because of the expiration of the corporate level statute of limitations. Thus, arguably, a corporate proceeding should have been initiated to determine partnership item contributions prior to the issuance of an affected item notice for basis/loss limitation.

N.C.F. Energy Partners, may be distinguished, however. Additions to tax were at issue in that case. Before the additions could be determined, the tax had to be determined. The tax could only be determined pursuant to a partnership level proceeding. Furthermore, we have taken the position that if a court has jurisdiction over affected items, it has jurisdiction over the subcomponents of the affected item even if these subcomponents would be partnership items if raised at the partnership level.

For instance, depreciation on an asset may be disallowed in a partnership proceeding without adjusting the basis of the asset, although basis of a partnership asset is a partnership item which was raised as an alternative ground for disallowance. In a subsequent affected item proceeding, for purposes of the overvaluation penalty under section 6659, the basis of the asset must be determined. In such cases we have raised basis of the property in the context of an affected item proceeding even though this subcomponent of the overvaluation penalty is also a partnership item when raised at the partnership level.

In this regard, the items determined at the partnership level may be viewed as merely evidentiary in nature to the extent they relate to the separately determined issue in the affected item proceeding. To the extent subcomponents of basis are not determined at the entity level, for whatever reason, we believe they should be assertable for the first time in an affected item proceeding.

Since these issues remain to be resolved, as a protective measure, we generally recommend that subchapter S items which will affect basis be determined at the entity level. Even if the

Court refuses to make these determinations at the entity level, the Service would still have one year to issue affected item notices of deficiency after the TEFRA proceeding is complete. I.R.C. § 6229(a) and (d).

In the present case, however, it is too late to initiate a TEFRA proceeding for the [redacted] and [redacted] taxable years. The period of limitations on assessing subchapter S items has expired without a notice of FSAA having been issued. If the Court should hold that the determination of basis depends on partnership items which must be determined at the partnership level, then the Court will dismiss the case for lack of jurisdiction. See Maxwell v. Commissioner, supra; N.C.F. Energy Partners, Ltd. v. Commissioner, supra. Arguably, however, the determination of the shareholder's basis and the consequent loss limitation pursuant to section 1366(d)(1) are not dependent on the outcome of an entity level proceeding under Roberts v. Commissioner, supra. If the Court views the subchapter S item components of basis which could be determined at the entity level as merely evidentiary in nature with respect to the separately determined issue of basis, jurisdiction may be proper in the present case.

Even if jurisdiction is proper, however, the affirmative defense of an expired period of limitations on assessment must be decided.

STATUTE OF LIMITATIONS

Generally, the period for assessing partnership items and affected items is section 6229(a). The period for assessing nonpartnership items is provided by section 6501. This office subscribes to a "separate statute" approach, under which section 6229(a) applies exclusively to partnership items and affected items and section 6501 applies exclusively to nonpartnership items. See Litigation Guideline Memorandum TL-81.

The period of limitations on assessment under section 6229(a) expired with respect to the affected item at issue in this case before a notice of FSAA or affected item notice of deficiency was issued. Since the relevant period of limitations on assessment has expired, the Service should concede this issue with respect to the [redacted] and [redacted] taxable years.

As a final matter, we note that petitioner alleges that, under Kelley v. Commissioner, supra, the period for assessment under section 6501 with respect to the corporation as a separate entity must also be open with respect to the [redacted] (non-TEFRA) taxable year. In a fully reviewed and unanimous opinion, the Tax Court has stated that it will not follow Kelly in any other jurisdiction, other than the Ninth Circuit. Fehlhaber v. Commissioner, 94 T.C. No. 54 (June 13, 1990); but see Fendell v.

Commissioner, Slip Opinion No. 89-1987 (8th Cir. June 22, 1990)(following Kelley in trust case scenario). We understand that this case is appealable to the Third Circuit.

CONCLUSION

In accordance with our instructions we understand that you have conceded the [redacted] and [redacted] taxable years but have objected to petitioner's motion for summary judgment with respect to the [redacted] taxable year.

Please refer any questions you may have on this matter to Bill Heard at FTS 566-3289.

MARLENE GROSS

By: Curtis G. Wilson

CURTIS G. WILSON
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